United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL
WITH PROOF
OF SERVICE

76-7462

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P/S

UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

DOMACO VENTURE CAPITAL FUND, a limited partnership,

Plaintiff-Appellant,

-against-

TELTRONICS SERVICES, INC., SHASKAN & CO., INC., CLAUDE C. CONTI, EDWARD M. BEAGAN, THOMAS R. RAMSEY, DAVID A. LaCONTE, GERARD F. HUG, GILBERT MONICK and JEFFREY A. MOROSS,

Defendants.

TELTRONICS SERVICES, INC., EDWARD M. BEAGAN, DAVID A. LaCONTE, GERARD F. HUG, and GILBERT MONICK,

Defendants-Appellees.

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF THE APPELLANT

BERMAN AND ZIVYAK
Attorneys for Appellant
450 Park Avenue
New York, New York 10022
(212) 593-1570

(5850B)

COUNSEL PRESS, INC., 55 West 42nd Street, New York, N.Y. 10036 • PE 6-8460

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-against-	:	
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Appellees.	:	

PRELIMINARY STATEMENT

This is an appeal from an order entered in the United States District Court for the Southern District of New York (Hon. John M. Cannella U.S.D.J.) denying plaintiff-appellant's motion pursuant to Rule 23 Fed. R. Civ. P. for class action status.

QUESTION PRESENTED

May the mere assertion of a permissive counter-claim against a proposed class plaintiff act without factual underpinning, act to render that plaintiff unable to fairly and adequately represent a class?

STATEMENT OF FACTS

Plaintiff-appellant Domaco Venture Capital Fund ("Domaco") appeals from the order of the Hon. John M. Cannella dated August 10, 1976. That order denied Domaco's motion made on September 12, 1974 pursuant to Rule 23, Fed. R. Civ. P. for designation as a class representative.

Domaco, along with an estimated several hundred others purchased the stock of the defendant-appellee Teltronics Services, Inc. ("Teltronics") upon its initial offering to the public, pursuant to a Prospectus dated January 9, 1973. In general, the complaint alleges that the Prospectus contained material misrepresentations and asserts private rights of action on its own behalf and on behalf of other purchasers of Teltronics stock similarly situated. The sufficiency of the complaint is, of course, not at issue here.

The defendants, Teltronics and those of its officers and directors who could be served, joined issue. Essentially, they asserted general denials, the usual affirmative defenses to securities class actions and no counterclaims. Domaco then timely moved for Rule 23 treatment.

During the course of the motion practice involving that motion, the following essentially undisputed facts developed.

Domaco Company ("Company"), a partnership is Domaco's sole general partner. In turn, Mr. Jack Polak ("Polak") is a Company's general partner. Polak individually and through a corporate entity, Equity Interest, Inc. rendered investment advice to many accounts including Domaco. Equity was and is a registered investment advisor. In this connection, there is no dispute but that Polak made the investment decision for Domaco to buy Teltronics stock when it was first offered to the public. The facts developed also disclose that the lead underwriter for the public offering of Teltronics stock Shaskan & Co., Inc. ("Shaskan") became the principal market maker of Teltronics stock in the over-the-counter market. One, Stanley Bartels, a registered representative at Shaskan had a long standing relationship with Polak. There is no dispute that Bartels' advice played some part in Polak's initial decision to invest his money and the money of his clients in Teltronics stock. It is here where the parties part company on the facts.

Shaskan closed its doors on June 20, 1973. The defendants claim that Bartels, well in advance of June 20, 1973, told Polak of Shaskan's financial difficulties, a contention which Polak denies. As a result of this contention,

the plot becomes even more byzantine. Teltronics, after the Rule 23 motion had been made, moved for leave to serve and file an amended answer which asserted counterclaims against Domaco, third-party claims against Polak and Equity Interest as well as assorted other third-party cross-claims and counterclaims.

The underlying theory of these assorted claims is as follows:

For some reason, in the months just prior to Shaskan's demise, Teltronics was a buyer of its own stock for some reason (perhaps attempting to buoy up its own stock price, but that must be left for a later day); at the same time, so the scenario gives, Polak advised of Shaskan's imminent demise by Bartels, an act unknown to Teltronics, was busy selling the Teltronics stock that Teltronics was presumably buying; since Polak was selling stock belonging to his investment clients and to Domaco based on inside information not known to Teltronics, Teltronics was a defrauded buyer with SEC Rule 10b-5 concepts.

Thus, Teltronics urges that this somehow gives rise to a right of contribution or quasi-indmenity as against Domaco, Polak and Equity Interest. We must confess some grudging admiration for the unflagging ingenuity of counsel, as they convinced the court below that these bare allegations were of such import as to disqualify Domaco as a fair and

adequate representative of the class.

Let's look at the record. Despite the welter of charges and counter charges, theonly facts which have emerged show that Domaco and other Polak clients owned 9,500 shares of Teltronics stock when Bartels allegedly told Polak about Shaskan's problems. Some two months later, when Shaskan ceased doing business, the Domaco-Polak group still owned 6,480 shares. If Polak was a "tippee", he surely was not very good at it. Polak denied receiving inside information. Bartels denies giving it. The places where these allegations are found are in the amended answer (a pleading, but nonetheless an anonymous source) and an attorney's affidavit who admittedly did not have any personal knowledge of the facts. Thus, the state of the record is that Polak is merely charged with improper conduct. Apparently, the District Court has adopted as a standard that which was imposed upon Caesar's wife. We suggest that that standard is unfair.

This area of the law is an important one and one which is in flux. The decision of the court below is based upon pure fiction; it is wrong and it cannot be permitted to stand for it is destructive of the very public policy of Rule 23 which is designed to encourage an able class member to represent persons who are similarly situated.

The issue raised on this appeal is not whether Domaco should be denied class status because its driving force used inside information relating to the securities which are the subject matter of the class claims. Rather, the question is whether such disqualification may rest on the mere allegation of the use of inside information. One thing above all must be remembered, the state of the record is that Mr. Polak did not trade on inside information.

DISCUSSION

Regardless of how the appellees attempt to contort the facts, the claims they have conjured up are the basis for nothing more than a permissive counterclaim with some ancillary claims thrown in for good measure.

Thus, the complaint seeks relief on behalf of the class because the Prospectus, pursuant to which the class purchased Teltronics stock when it was first offered to the public.

The counterclaim alleges that, in the after-market, Polak learned facts extrinsic to the worth of Teltronics stock -- Teltronics' market maker was going to "go broke" and that the bottom was going to fall out of Teltronics stock.

Is there any doubt, but that the defendants claim is ". . . against an opposing party not arising out of the transaction or occurrence that is the subject matter of the opposing party's claim." Fed. R. Civ. P. 13(b). While the defendants have tried to create a transactional nexus between the complaint and the "facts" in the counterclaim, there is none. Their two claims merely involve the same securities and nothing else.

Where then does the idea of besmirching Mr. Polak come from? This is obvious, it comes from a reading of Polak v. Noel Industries, Inc., 64 F.R.D. 333 (S.D.N.Y. 1974). In that case, Catharina Polak, the wife of Jack Polak sought a determination that she was an adequate class representative in that SEC Rule 10b-5 action. Her motion was opposed upon the grounds that ". . . the named plaintiff would not represent the class fairly because her husband may be liable to suit in connection with the purchasers of . . . stock which he advised." Judge Pollack rejected this argument and wrote:"

> "However, defendants have not pointed to any allegations whatsoever against Mr. Polak by anyone in this regard; nor does there, in the present record, seem to be any evidence of impropriety on the part of Mr. Polak."

What has happened in this case to make it differ from Polak v. Noel, supra? The answer is obvious. The defendants here read Polak v. Noel and took Judge Pollack at his word and invented " . . . allegations against Mr. Polak . . ." Indeed, it is respectfully submitted, this Court

should give no more credence to the assertions of misconduct against Mr. Polak because they appear in a pleading rather than in some affidavit submitted in opposition to a Rule 23 motion. This is distinction without a difference. At the very best, the defendants have shown that there is a scintilla of a possibility of a conflict arising in the future. Thus, we turn to those cases where a challenge has been made to class status because of some potential conflict.

In Lamb v. United Security Life Company, 59 F.R.D. 25 (S.D. Iowa 1972), a security class action, the defendants opposed a Rule 23 motion on the ground that the proposed class representative was a director of the merged out corporation. The plaintiff had gone so far as to have voted ". . . for the several resolutions which effected the exchange. . . stock and the subsequent merger . . ." Id. at 30. Thus, in Lamb, unlike the case at bar, the proposed former class representative was an insider who had participated in the very transactions challenged in the complaint. Here, on the other hand, Polak's involvement, if it exists, is in a transaction separate, apart from and subsequent to the one sued upon. In granting the Rule 23 motion in Lamb, the court stated:

> "It appears to the court that, notwithstanding the fact that Mr. Seale was a director, there are sufficient allegations that he was a victim of fraud and misrepresentations not distinct from the rest of the stockholders. He asserts his interests here in that capacity.

> His personal liability, if any, might be relevant in a deprivative action, precluding his participation as a plaintiff therein, but the Court cannot see anything in Mr. Seale's former status at this time antagonistic to or in conflict with other sought to be included in the class, although he might eventually, upon trial of this cause, be defeated upon his individual claim by reason of that status, just as other plaintiffs may be individually defeated by other defenses. Concededly, Mr. Seale is not the average uninformed investor, but this does not require either the conclusion that he cannot protect and vigorously assert the interests of others in the class, or that his interest in redress of the fraud and misrepresentation alleged is not identical to those he seeks to represent." (Footnote omitted)

We continue with Maynard, Merel & Co. v. Carcipoppullo, 51 F.R.D. 273 (S.D.N.Y. 1970), a case which while denying class status is most helpful to the Appellant by virtue of the legal principals it espouses. In Maynard, the moving party seeking class designation had been the underwriter of a public offering of the stock of a company which was being "merged out". As a result of the merger, the plaintiff lost a "first refusal" to underwrite any prospective public offering of the merged out company. This right of first refusal which it was seeking to recover by compelling rescission of the merger differentiated it substantially from other "merged out" potential class members who obviously would be satisfied with money damages. Thus, Judge Mansfield wrote:

> Even if the complaint were amended as plaintiffs request, it does not appear that plaintiffs would fairly and adequately protect the interests of the class which they seek to represent, i.e., the other Carci shareholders at the time of the merger. Their interests are potentially adverse to those of the other class members in that the harm which they have suffered from the merger is unlike that of any Carci shareholder and consequently the relief they most desire (rescission) might not be satisfactory to the others. For services rendered in the Carci public offering of June 1969, both plaintiffs received, in addition to substantial cash and stock commissions, rights of first refusal with respect to underwriting of future public offerings of Carci. In addition, Sealfon received a financial consulting fee and the right to designate one director of Carci. Since the rights of first refusal and the one Carci directorship have not survived the merger of Carci into Cybermatics, the only way Merel and Sealfon can avoid losing them is by obtaining a mandatory injunction to undo the merger which they now seek. Their paramount interest in undoing the merger or in liquidating through other means the rights which they are threatened with losing creates a high potential for conflict with the interests of the other members of the class. Specifically, they are less likely than other former Carci shareholders to accept the offer of a cash settlement, eventhough such a settlement might be desired by other class members and in fact, be in the best interests of the class. (emphasis added)

Here on the other hand, Domaco's primary interest (and of course the primary interest of Mr. Polak)is to seek money damages for itself and similar money damages for absent class members. The conflict apparent on the face of Maynard simply does not exist here.

In First American Corporation v. Foster, 51 F.R.D. 248 (N.D. Ga. 1970) a Rule 10b-5 class action was brought by former officers of the subject corporation. It appears that the plaintiffs had been ousted from management after an internal struggle. Hence, their Rule 23 motion was opposed because of their former association:

In granting the motion, the court wrote:

> "Defendants' allegation of an antagonism between plaintiffs and other class members standing alone is not enough to require that the action not be allowed to proceed as a class action. Such antagonism must be as to the subject matter of the suit.
> Id. at 250 (emphasis added)

It is clear that the counterclaims, cross claims and third-party claims were drafted with one eye on the case law representative by Lamb, Maynard and First American. There is a strong attempt to link the prospectus fraud of which the defendants are accused to the allegedly improper after market transactions. It is a classic attempt to stretch"the facts" to a procrustean framework; but it just won't wash.

Thus, reading Lamb, Maynard and First American together, we learn that the antagonism or conflict which would defeat a Rule 23 motion can be defined as difference in goals of the litigation as between the proposed class representative and the absent class members. This case clearly demonstrates that no such conflict exists, since Domaco seeks relief (i.e. money damages) which is qualitatively identical to the relief sought on behalf of the class. Unlike Maynard, but like Lamb and First American, the plaintiff receives no special benefit from recovery which makes

it different from absent class members.

As many cases have observed, there is something internally inconsistent and disingenuous with the opposition to a Rule 23 motion on the grounds that representation is inadequate. Upon analysis, defendants are saying 'don't let this man represent a class because he won't get a big enough judgment or a favorable enough settlement.' See Umbriac v. American Snacks, Inc. 388 F. Supp. 265 (E.D.Pa. 1975); Madonick v. Denison Mines Ltd., 63 F.R.D. 657 (S.D.N.Y. 1974). This unfortunately is not the first case in which such opposition was firmly grounded in nothing more than attempted character assasination. That was the tactic adopted in Cook Investment Co. v. Harvey, ¶95,203 CCH Fed. Sec. L. Rptr (N.D. Ohio 1975)

Judge Walinski's words words in rejecting such an argument are all too applicable here:

> "Defendants' principal argument seems to be that the plaintiffs will not fairly and adequately protect the interests of the class. Although defendants have filed several briefs on this motion, the court has had considerable difficulty in discerning the nub of their argument that plaintiffs are not proper representatives of the class. Unfortunately, the court feels constrained to concur with plaintiffs that many of defendants' contentions amount to an argumentum ad hominem. Although, by its very nature, an argument attacking a plaintiff as an inadequate representative of a class is something of an argumentum ad hominem, this kind of dialetic requires something more than mere "poisoning the well." Once a plaintiff has shown the requisite stake in the outcome and that counsel is competent to conduct class action litigation, it is incumbent upon those opposing the class action to show how a plaintiff will not adequately

> protect the interests of the class. Defendants herein have made several accusations, but they have not shown how these accusations even if true somehow disable the plaintiff ... from representing the class. The court thus finds it very distressing that so much verbiage sheds so little light on an issue. ... Even assuming that all of these contentions are true, it is difficult for this court to understand how they disable plaintiff . .. from being the class representative in the face of his ownership of 100 shares of stock and plaintiffs' counsel's apparent expertise in class litigation.

We must always return to the defendants' claims against Domaco, Polak and Equity and understand why they are asserted. It is an attempt to show that Domaco, through Polak, has some special axe to grind and that therefore, Domaco cannot fairly and adequately represent the class. This is no bona fide attempt to recover on the counterclaims, just a vehicle for launching a defense to a class action motion.

In Dorfman v. First Boston Corp., 62 F.R.D. 466 (E.D. Pa. 1974), the motive of one of the proposed class representatives was questioned. That plaintiff had retained eight of its original 600 debentures "as a matter of principle... to see this action through." Id. at 473.

In rejecting defendants' arguments concerning the efficacy of the proposed class action, Judge Lord said,

> "... principle coupled with the hope of rectifying a claimed loss and the prospect of a substantial recovery, may be as strong a spur to vigorous prosecution as many other motivations." Ibid

A synthesis of the applicable law reveals that a proposed class representative will not be disqualified simply because he has a more intimate knowledge of the corporation's inner workings as Polak might because he is a sophisticated investor. Mersay v. First Republic Corp., 43 F.R.D. 465 (S.D.N.Y. 1968); see also Reichlin v. Wolfson, 47 F.R.D. 537 (S.D.N.Y. 1969).

Indeed, hypothetical liability resting against the plaintiff or his motive for bringing the suit sill not defeat the motion. Vernon J. Rockler & Co. v. Graphic Enterprises, Inc., 52 F.R.D. 335 (D. Minn. 1971); First American Corp. v. Foster, supra.

The test then is whether the class representative's departure from the norm of the absent class member is such that he will not vigorously pursue the rights of those absent class members. It is submitted that a simple review of the docket sheet in this case demonstrates the vigor of plaintiff's prosecution of this action. Nothing more need be said in this regard.

We also point to the position taken by many courts in similar situations. See Dorfman v. First Boston Corp., supra; In re Goldchip Funding Co., 61 F.R.D. 592 (E.D. Pa. 1974). A District Court has the power to review its orders in a class action at any time during its pendency pursuant to Rule 23(d) (2).

Class Action status should not be denied in limone because the defendants speculate that representation will not be adequate in the future. The plaintiff should be entitled to demonstrate the vigor of his representation. If it fails, then it will be stripped of his mantel. Indeed, as has been commented in a similar situation:

> "I must say that defendants' concern that they may not be exposed to the greatest possible liability if plaintiff's motion is granted is indeed touching." Madonick v. Denison Mines Ltd., 63 F.R.D. 657 (S.D.N.Y.).

We turn then to the one case relied upon by the court below, G.A. Enterprises, Inc. v. Leisure Living Commun, Inc., 517 F. 2d 24 (1st Cir. 1975). That case is totally distinguishable from the case at bar. In G.A. Enterprises a derivative actic[illegible]s brought and the proposed representative plaintiff was found by the district court to be unable to fairly and adequately represent on the interests it sought to represent one Katter was the principal of the plaintiff and the Court described the relationship among Katter, G.A. Enterprises and Leisure Living as follows:

> Katter, who besides controlling GA also controls other companies, had in 1970 entered into complex business arrangements encompassing the sale of various Kattar controlled entities and assets to Leisure Living. That arrangement soon turned sour spawning litigation between Kattar and his companies, on the one hand, and Leisure Living on the other. A Kattar company other than GA has sued Leisure

> Living for liquidated damages and equitable relief upon an agreement by Leisure Living to pay that company $50,000 a year plus an option on 20,000 shares of stock. Leisure Living had itself sued a second Kattar-controlled corporation in the District of Maine, and was awarded a judgment (recently affirmed by this court) for $240,000 plus interest. A trustee attachment and preliminary injunction against still another Kattar-controlled enterprise was obtained by Leisure Living in Massachusetts to secure satisfaction of that judgment. Other cross claims and obligations exist. Id. at 25.

Judge Campbell speaking for the First Circuit then quoted from the District Court's opinion as follows:

> "all the claims taken together are sufficiently adverse to the interests of the shareholders to require dismissal of the action. It is the totality of the relationship between the Kattar companies and Leisure Living which mandates this conclusion. Were there simply one pending suit between the parties it is quite possible that the same result would not obtain. The Court is fearful that, given the complex business arrangements involved, this suit, as one of several between the parties, runs the risk of losing its special character as a derivative suit." Id. at 26.

Judge Campbell then went on to state:

> GA's own interests, or at least the interests of its principal, suggest that from its standpoint the "highest and best" use of the derivative suit would be as a weapon in the total Kattar arsenal, to be either pursued, de-emphasized, or settled as the future course of the larger claim might dicate.

> Since the suit threatens Leisure Living's managers with individual liability, it provides leverage that could affect how doggedly they pursue Leisure Living's own claims and defense against Kattar in other areas. So manipulated, the derivative suit would serve interests beyond and perhaps contrary to those of the other minority stockholders. (emphasis added, footnotes omitted)

Thus, it is clear that what concerned the court in G.A. Enterprises and what prompted the court the affirm the denial of representative status was that the reason for the seeking of representative status was not the reason found on the face of the complaint - there was an ulterior motive. Such a finding was entirely consistent with the state of the facts prior to the commencement of the derivative action in G.A. Enterprises.

This is to be contrasted with the facts here. Domaco's and Polak's first contact with the defendant's was the purchase of the securities here sued upon. That the defendants have conjured up some conduct after the sued upon transaction and have tried to "bootstrap" that claim into a conflict of interest is not surprising and is nothing more than a self fulfilling prophesy.

This is also the basis for distinguishing Hornreich v. Plant Industries, Inc., 535 F. 2d 550 (9th Cir. 1976) the case at bar. Once again in Hornreich the derivative suit was

but one of a series of pending litigations and was (at least in the view of the Court of Appeals) being used as a weapon in an internal corporate dispute. Neither G.A. Enterprises nor Hoffreich is applicable to the case at bar.

The policy of Rule 23 is ill served by disqualifying persons or entities like Domaco from representative status. Indeed we appear to have come full circle. How long ago was it when we heard the hue and cry of defense counsel attacking as an improper class representative the odd lot trader with a $70 claim. Such a class representative it was argued was a stooge for his attorneys with niether a real stake in the outcome of the litigation nor an understanding of what the litigation is about.

Now we have a proposed class representative who has a real loss and can make a meaningful contribution to the conduct of the litigation. Obviously the more sophisticated the investor the more likely it is that he be subject to attack through the counterclaim device or through the claim of atypicality. The sophisticated investor is more likely to have made an independent investigation of the subject matter of this suit he is more likely to have had direct contact with the defendants; yet this is the kind of class representative who should be encouraged because he is a bonafide litigant and not a straw man.

The sophisticated class representative is fully prepared to defend the counterclaims against him. He is not, nor should he be prepared to be barred from representing a class because of the assertion of those claims.

CONCLUSION

THE DENIAL OF THE APPELLANT'S MOTION FOR CLASS ACTION STATUS WAS ERROR AND IS SHOULD BE REVERSED WITH DIRECTIONS TO THE DISTRICT COURT THAT THE MOTION BE GRANTED.

Respectfully submitted,

BERMAN AND ZIVYAK
Attorneys for Appellant
450 Park Avenue
New York, New York 10022
(212) 593-1570

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

ALLEN Q HAYES, being duly sworn, deposes and says that deponent is not a party to the action, is over 18 years of age and resides at 162 MAY WLK Apt 6A Brooklyn NY. 11201.

That on the 15 day of NOVEMBER, 1976, deponent personally served the within BRIEF OF THE APPELLANT upon the attorneys designated below who represent the indicated parties in this action and at the addresses below stated which are those that have been designated by said attorneys for that purpose.

By leaving 2 true copies of same with a duly authorized person at their designated office.

~~By depositing _____ true copies of same enclosed in a postpaid properly addressed wrapper, in the post office or official depository under the exclusive care and custody of the United Stated post office department within the State of New York.~~

Names of attorneys served, together with the names of the clients represented and the attorneys' designated addresses.

WEIL GOTSHAL & MANGES
ATTORNEYS FOR DEFENDANTS-APPELLEES
767 FIFTH AVE.
NEW YORK, N.Y. 10022

Allen Q. Hayes

Sworn to before me this
15 day of November, 1976

Michael DeSantis

MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Bronx County
Commission Expires March 30, 1977